Statement of

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Before the

Subcommittee on Commercial and Administrative Law
House Committee on the Judiciary
U.S. House of Representatives

H.R. 4019
Relating to State and Local Taxation of Certain Payments to Retired Partners
December 13, 2005

Chairman Cannon, Congressman Watt and Members of the Subcommittee:

Thank you for the opportunity to appear before the Subcommittee on H.R. 4019 relating to state and local taxation of certain payments to retired members of partnerships. My name is Harley Duncan, and I am the Executive Director of the Federation of Tax Administrators. The Federation is an association of the principal tax administration agencies in the 50 states, the District of Columbia and New York City. My purpose today is twofold: (1) to request that the Subcommittee require the proponents of the bill to demonstrate with clear and convincing evidence that the source principle of taxation should be overridden because of concerns regarding the administrative and recordkeeping burden associated with taxing retirement income paid to retired partners in the source state; and (2) to request that, if the Subcommittee determines it is appropriate to move forward with this bill, that it take steps to improve the clarity and precision of the bill in order to prevent the bill from creating opportunities for substantial avoidance.

H.R. 4019 would amend P.L. 104-95 by including in the list of specific distributions from specific types of retirement plans that may be taxed only by the state in which an individual resides or is a domiciliary a new category of income characterized as “any plan, program or arrangement providing for retirement benefits to a retired partner (treated as such under applicable tax laws)….” It would also liberalize the requirement that distributions from nonqualified deferred compensation plans (and the newly included partnership retirement benefits) be made not less frequently than annually and that the distributions be made in substantially equal amounts.

Introduction

As a preliminary matter, it should be stated that to this point, there has been no discussion with the Federation or its staff as to the need for H.R. 4019. We understand there is a desire to bring parity to the tax treatment of various streams of income that some consider “identical,” and that there are issues of administrative burden that have been raised. These, however, have not been explained to or discussed with us. We believe that the Subcommittee as a first order of business should require the proponents of the bill to demonstrate clearly that the administrative and recordkeeping burden associated with taxing the retirement income in question is so onerous as to require a modification of the source principle of taxation, which would hold that the income in question should be taxed where the services giving rise to the income were performed even if the taxation is deferred until the income is actually received. Simply saying that the income in question is the “same as that covered by an earlier act of Congress” (P.L. 104-95) is insufficient without further evidence.

The Federation was an active participant in the discussions surrounding the passage of P.L. 104-95 and worked closely with this Subcommittee in developing the final shape of the legislation. Then, as now, we recognize that the source principle of taxation must be balanced with administrative difficulties and burdens that might be imposed on taxpayers and their employers in maintaining sufficient records over a lifetime of income to ensure an appropriate allocation of the deferred income among all states in which it might have been earned. At the same time, proponents of P.L. 104-95 and Members of this Subcommittee recognized that any limitations imposed on state and local taxing authority should be narrowly and clearly drawn so as to accomplish their intended purpose, but not to create unintended consequences and open up opportunities for substantial tax avoidance. We think the same considerations are appropriate in deliberations regarding H.R. 4019.

During testimony before this Subcommittee on legislation that ultimately became P.L. 104-95, FTA offered the following statement:

> As a general matter, the Federation urges the Congress to move cautiously in considering legislation to restrict the ability of states to tax retirement income paid to former residents. Any such legislation should: (1) preserve to the maximum extent possible the source taxation principle under-girding state income tax systems; (2) not create opportunities for substantial tax avoidance; (3) be designed carefully to address the issues present in today's environment and not a series of hypothetical situations which someone might conjure; and (4) be capable of being administered by being precisely drawn and based upon references to current laws or understood concepts where possible.[1]

P.L. 104-95 substantially follows these principles in that it specifically identifies the types of retirement income that are taxable only in the state of residence by defining them with respect to specific sections of the Internal Revenue Code. As to non-qualified deferred compensation plans, which are by definition variegated arrangements, the legislation imposed standards for the length and amount of distributions so as to avoid potentially abusive situations where an individual could defer substantial amounts in the latter part of a career, move to a non-tax state and avoid substantial taxes to the state in which the income was earned. P.L. 104-95 provides a good model to follow should the Subcommittee determine that the administrative burdens associated with continuing to tax the income in question at the source are too onerous. Any limitation should be clear and unambiguous.

Source Tax Principle

There should be no question regarding the legal authority of states to tax the retirement income of nonresident partners where the services giving rise to the income were performed in the state.[2] The basis of current state income tax systems is that a state may tax income that is

[1] Testimony of Harley T. Duncan before the Commercial and Administrative Law Subcommittee of the House Committee on the Judiciary, "State Taxation of Nonresident Pension Income," June 28, 1995.

[2] Throughout the testimony, references to nonresident pension or retirement income should be read to refer to that portion of any deferred compensation arrangement that is attributable to services performed in the state at an earlier point in time. A state would not have authority to tax pension income of a nonresident if it did not arise from services or other activities performed in the state.

derived from sources within the state, regardless of whether it is earned by a resident of the state or a nonresident engaging in income-producing activities within the state. In-state sources are generally defined to include the performance of services in the state, the conduct of a trade, business or occupation in the state, or the receipt of income from property owned within the state.

State authority to tax nonresident income from in-state sources was validated by the U.S. Supreme Court over 70 years ago in *Shaffer v. Carter* 252 U.S. 37 (1920) when it wrote:

> ...we deem it clear, upon principle as well as authority, that just as a State may impose general income taxes upon its own citizens and residents..., it may, as a necessary consequence, levy a duty of like character, and not more onerous in its effect, upon incomes accruing to non-residents from their property or business within the State, or their occupations carried on therein....

As the *Shaffer* court noted, and as has been developed in subsequent cases, the essential constraint on the states in the taxation of nonresident income is that the nonresident may not be taxed to a greater degree than a similarly situated resident of the state and may not be discriminated against by virtue of the nonresident status.[3] It is also clear that states have authority to tax all income received by a resident, regardless of the source of that income.[4] To avoid double taxation, however, all states with a broad-based income tax[5] provide a tax credit to residents for income taxes paid to another state on income which is also included in the tax base of the state of residence.[6] This system of reciprocal credits generally prevents

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3 With respect to nonresident pension income in particular, states take the position that the pension income is simply deferred income or compensation for services performed at an earlier point in time. This issue has not been addressed directly by the Supreme Court. The Court's ruling in *Davis v. Michigan Department of Treasury* 109 S.Ct. 1500 (1989) (intergovernmental tax immunity and 4 U.S.C. 111 prevent a state from taxing federal pensions to a greater degree than they do state and local pensions), however, certainly supports the state interpretation that pensions are deferred income paid for services performed previously.

4 *New York ex. rel. Cohn v. Graves*, 300 U.S. 308 (1937) and *Lawrence v. State Tax Commission*, 286 U.S. 276 (1932).

5 Forty-one states and the District of Columbia levy a broad-based personal income tax. New Hampshire and Tennessee levy an income tax on limited types of interest, dividend and capital gains income. Alaska, Florida, Nevada, South Dakota, Texas, Washington and Wyoming do not levy a personal income tax.

6 Maine and Virginia do not grant such a credit on retirement income. Neither state, however, includes retirement income from non-state sources in the tax base of the resident.

retirement (and other) income from being taxed in both the state in which it is earned and in the state of residence.[7]

As noted, the principle of source taxation must be balanced with issues concerning the administrative and compliance burden that may be imposed on individual taxpayers and their employers in maintaining the records necessary to appropriately allocate income among states and filing the requisite returns. For example, Congress has limited the taxation of individuals engaged in most interstate transportation industries to the state of residence or where the taxpayer spends a majority of his/her time in recognition of this type of burden. It was these sorts of concerns that also were the genesis for P.L. 104-95. As Congress has recognized in its earlier deliberations, if limits are to be imposed on state taxation, care must be taken to ensure that the limits are clear and precise and that they do not create opportunities for unwarranted tax avoidance.

Issues Relative to H.R. 4019

The Federation believes that H.R. 4019, as drafted, falls short of this goal and the criteria outlined earlier in this testimony. Specifically, we have three concerns with H.R. 4019: (1) Certain terms and phrases used in H.R. 4019 are unclear and require further specific definitions; (2) Without greater clarification and precision, H.R. 4019 creates opportunities for substantial, unwarranted tax avoidance; and (3) The effective date in H.R. 4019 should be changed.

Lack of precision. In subsection 1(a)(1) of H.R. 4019, the term "retirement benefits" is used, but not defined in any way.[8] By contrast, P.L. 104-95 goes to great length to define the term "retirement income" with specific reference to sections of the Internal Revenue Code. This not only provides specificity for administrative purposes, but ensures that the income is actually retirement income in the normal sense of the term, where income has been systematically set aside in a trust arrangement to be paid out when one ceases work. Without any definition, H.R.

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[7]Certain groups of states do not use such a system of credits. Instead, they have reciprocal agreements under which all income is taxed by the state of residence rather than the state in which it is earned. (This also avoids taxation by two states.) These agreements are most prevalent in the Virginia-D.C.-Maryland, Pennsylvania-New Jersey, and Ohio-Indiana-Illinois areas.

[8] Other than, we presume, by the current law's limits regarding the length of payouts and the "substantially equal" requirement that govern distributions from nonqualified deferred compensation arrangements.

4019 would potentially allow nearly any stream of post-employment income to be characterized as "retirement income" and made free of tax if one resided in a non-tax state. We would suggest that the Subcommittee consider IRC section 1402(a) as a potential definition for "retirement benefits." The section defines income of former partners that are not subject to self-employment tax and may be a model for H.R. 4019.[9]

The phrase "retired partner (treated as such under applicable tax laws)" [Section 1(a)(1)] is presumably designed to define the types of individuals that qualify for the limitation. Without further specificity, however, it is simply a phrase without meaning. It will become a point of contention and litigation and creates opportunities for recipients to try to avoid tax by characterizing themselves as "retired partners." The phrase must be defined with reference to the specific tax laws that help define "retired partner" or otherwise provide a statement of the qualifications that define one as a retired partner if it is to be administrable and enable taxpayers and states alike to determine who qualifies for the special treatment.

The meaning and intent of Section 1(a)(2) is unclear and requires explanation. On its face, it modifies the "substantially equal periodic payments" test imposed on distributions from nonqualified deferred compensation plans to enable what are being touted as "retirement benefits" to be paid under some non-normal schedule. This would seem to open up the bill to gaming by allowing the partnership benefits to be paid on some other basis. If the purpose of H.R. 4019 is to replicate P.L. 104-95, this modification should be deleted. The effort in P.L. 104-95 was to place a limit on what all considered to be "normal" retirement plans. The "substantially equal" requirement was designed to ensure that nonqualified plans could not easily be used to avoid tax liabilities.[10]

The phrases "predetermined formula" and "similar adjustments" in Section 1(a)(3) also need to be defined, if indeed the terms are even necessary. If those terms remains undefined, they become points of potential conflict and litigation. Also, such adjustments could be

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[9] This reference is provided as a possibility for further analysis. It has not been reviewed widely by states to determine if it would be suitable. It is an example, however, of the benefits of tying the definition in H.R. 4019 to other sections of the Internal Revenue Code.

[10] Note also that the term "period" in page 2, lines 13 and 14 of the bill should be changed to "periodic."

structured so as to effectively negate the ten-year/life-expectancy requirement and the "substantially equal" requirement, both of which are critical to limiting the use of nonqualified deferred compensation programs as tax avoidance techniques. While it is unclear why the language is necessary, such adjustments should be limited in some fashion, e.g., as a proportion of the total amount, not more than some percentage annually or the like.

Tax Avoidance. As noted, without precise and specific definitions of such terms as "retirement benefits" and "retired partner," there is a significant potential that income that is simply deferred (regardless of the reason) could be characterized as retirement income and thus be subject to the limitation in the bill. Depending on the state in which the individual lives at the time the income is received, it could turn a tax deferral into a tax exemption.

The greatest concern is that, given the lack of precision in the language, an individual that was a partner in a trade or business could sell the partnership interest and structure the pay-out so that it met the time period and "substantially equal" tests and argue that the income is retirement income subject to the limitation. In actuality, the income is gain on the sale of assets associated with the trade or business and is subject to tax in the state(s) in which the trade or business operated. However, without specific definitions of "retirement benefits" in the bill, there is a potential for the gain to be characterized as retirement income.

In addition to precisely defining what constitutes "retirement benefits," we would offer several additional suggestions of ways to avoid potential abuse of the limitation contained in H.R. 4019.

- The bill should be amended to state that proceeds from the sale of a partnership interest in a trade or business shall not be considered a retirement benefit subject to the limitation.
- The amount of retirement income subject to the limitation could be defined with reference to a particular level of income earned by the partner prior to retirement, e.g., income in excess of 110 percent of the average annual wages subject to wage withholding paid to the recipient by the partnership in the three years prior to retirement of the partner would not be considered retirement income.

- The limitation could be limited to income paid from plans or programs that existed for some time period (e.g., three years) prior to the time the partner retired.
- The term “retirement benefit” could be left to determination under state law, thus allowing the states to distinguish between retirement payments and proceeds from the sale of partnership interests.

Effective Date

As introduced, H.R. 4019 provides that the amendments shall be applied to income received after December 31, 1995. The effect is to retroactively apply the law change against the states. It would arguably allow those taxpayers that have voluntarily complied with those laws currently imposing tax on the affected income to file claims for refund. It would also negate any assessments states may have made. The change should be applied only to tax year 2006 and forward.

The implication of the retroactive date is that the states have in some fashion misapplied P.L. 104-95 and that P.L. 104-95 was intended to cover the types of income that is the subject of H.R. 4019. That is simply not true in my estimation. As an active participant in the discussion surrounding P.L. 104-95, it is true that retirement payments to retired partners were not considered when P.L. 104-95 was approved. It is incorrect to say that such income would be included within the terms of P.L. 104-95. If a taxpayer was assessed on tax that is considered to be within the terms of P.L. 104-95, she/he should contest the assessment through administrative appeals processes as opposed to pursuing federal legislation.

Conclusion

In conclusion, Mr. Chairman and Members of the Subcommittee, the Federation is committed to working with you further on this legislation if the proponents demonstrate to you the need for the legislation. We believe that H.R. 4019 as drafted is ambiguous and imprecise. It is likely to result in conflict and litigation regarding its interpretation and application Further work to clearly define what constitutes “retirement benefits,” who is a “retired partner,” and to avoid situations in which income could be re-characterized to take advantage of the limitations is necessary and we are willing to assist in this effort.